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VOL. CLIII NO. 111 Wednesday, June 8, 1988

Today

Bank Board Chairman M. Danny Wall hopes private investors can be attracted to the Southwest plan for rescuing Texas thrifts, but he said the cleanup will proceed even without them. — 2

Commercial banks earned $5 billion in the first quarter, up $1.8 billion from the previous quarter but down $300 million from the comparable period last year, the FDIC said. Excluding the massive loss of First Republic-Bank Corp., the industry would have earned a record $6.5 billion. — 2

Midwest regional bank stocks are on the way to becoming the darlings of the industry after two years of laggard performances, according to several recent reports by analysts. — 3

Americans of all incomes are pessimistic about their ability to achieve long-term financial goals, according to a survey released by the International Association for Financial Planning. 24

Consumer groups pushing for legislation to force banks to cash government checks are expressing concern over a possible compromise that would require the checks to be deposited electronically. — 24

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Branch profitability is much more than just the level of total deposits, writes Kenneth H. Thomas. — 4

Analyst David C. Cates looks at the rise and fall of international banks from a historical perspective, including the Medici Bank of Florence, which flourished and fell in the 15th century. 7

TECHNOLOGY

Union Bank of Switzerland's commitment to sophisticated telecommunications has helped it develop a strong international operation, which now accounts for half its assets. The bank pours approximately $70 billion into telecommunications each year, building and maintaining its own networks. — 10

Goldome Savings Bank, Buffalo, has chosen a satellite communications service to connect its mortgage banking offices in New York and Seattle. The high-speed voice and data transmission link will be provided by Safecom, Woodcliff Lake, N.J. — 10

Although critics of the Open Systems Foundation have been vocal, its backers insist the organization aims to serve all vendors and users of computer hardware and software. The supporters deny a bias toward IBM and say AT&T has been invited to join the foundation. — 12

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Worth Repeating

One hundred million people will now try to figure out how to beat their banks at float.

Consultant John Shain on the Expedited Funds Availability Act taking effect Sept. 1. [Page 14]

Panel Approves Bill Allowing All Banks into Massachusetts

By MICHAEL WEINSTEIN
New England Bureau

BOSTON — The banking committee of the Massachusetts legislature passed a bill that would open Massachusetts to banking companies nationwide effective Jan. 1, 1990.

The bill, which will include consumer protection and community reinvestment provisions, still has to be passed by the full Massachusetts House and Senate and signed by the governor.

The legislature often follows the lead of its committees. But there is still some opposition to the bill. The state's two biggest banking companies, the Bank of Boston Corp. and the Bank of New England Corp., oppose nationwide banking.

Paula W. Gold, secretary for consumer affairs and business regulation who oversees the banking department for the governor, supports a nationwide banking bill that includes provisions for consumer protection, community development programs, and local management presence.

A further element of uncertainty in Massachusetts politics is the presidential campaign of Gov. Michael S. Dukakis, which could influence a number of issues.

The bill does not include a provision to lower the tax rates on Massachusetts banks, which had been supported by

Massachusetts: Page 2 ➤

From Language to Laws, Global Bankers Wrestle with the Shape of the Industry

By ROBERT TRIGAUX

CHICAGO — Toru Kusukawa is jealous of his fellow global bankers. The deputy president of Fuji Bank Ltd., one of the world's largest financial institutions, said he believes Japanese banks suffer a major disadvantage in competing overseas because virtually no one uses the Japanese language to conduct international business.

"American and English bankers who can use their mother tongue to conduct international business have a great advantage. I must say I envy them," he says.

It's not easy managing a $50 billion, $100 billion, or $200 billion bank these days, as the top executives of more than 100 of the world's largest financial institutions readily admit during this week's lavish gathering of the annual International Monetary Conference.

At a meeting celebrated equally for its agenda of social entertainment as well as its big bank camaraderie, concern of language barriers may not dominate the debates on hostile takeovers and unequal regulatory treatment. But it does reflect the range of management problems besetting today's bank executives.

On Tuesday, the bankers met in private to argue the future composition of

International: Page 23 ➤

S&L Execs See Political Ploy In FSLIC Payout

Timing Tied to Bill Banning Exit from Insurance Fund

By ROBERT LUKE and JIM McTAGUE

Some California thrift executives believe politics played a role in federal regulators' move this week to liquidate two California thrifts at a whopping cost of $1.35 billion.

Liquidating American Diversified Savings Bank and North America Savings and Loan Association, both of Costa Mesa, will wipe out 42% of the Federal Savings and Loan Insurance Corp.'s cash.

"You have to look at the political timing of the action," said one thrift executive, who asked not to be identified. "Why not [move] in August, when Congress is out of session? The answer has to do with the moratorium."

Specifically, Congress is considering legislation to extend a one-year ban on thrifts switching to the Federal Deposit Insurance Corp. from the Federal Savings and Loan Insurance Corp., which assesses a higher premium. The moratorium is scheduled to expire on Aug. 10.

Federal Home Loan Bank Board Chairman M. Danny Wall, a former staff director of the Senate Banking Committee, supports the moratorium, which is vigorously opposed by thrift industry groups.

"I suspect that Danny Wall is scaring Congress to act," the thrift executive said, noting that the FSLIC is rapidly running out of funds.

The General Accounting Office, an arm of Congress, has estimated that at yearend 1987, the FSLIC's balance

S&L: Page 22 ➤

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June 8, 1988, American Banker

The Value of a Branch Is Measured in More than Deposit Ranges

By KENNETH H. THOMAS

SANFORD ROSE'S Feb. 17 column entitled "There's Still Hope For the Branch" presents a fairly balanced view of a vitally important retail banking topic, namely, the future of the branch.

The editorial did not dwell on the controversial finding by one consulting firm that around half of all branches are unprofitable and by implication should be closed. Rather, the comments focused on various strategies suggested by another consulting firm to enhance branch performance. Based upon that firm's experience with one regional bank with over 200 branches, those strategies reportedly could result in a remarkable turnaround: The proportion of branches exhibiting negative returns could fall from 48% to 10% or 11%, and the proportion earning less than the corporate hurdle rate could drop from 62% to 21%.

This case study emphasizes the importance of distinguishing between branches that are truly profitable and those that are not. A truly unprofitable (i.e., negative net present value) branch that is a chronic underperformer may have to be closed, sold, swapped, or otherwise disposed of. This branch disinvestment alternative is usually reserved for those problem or serious problem branches where locational (i.e., the site, immediate area, and market area) factors have been identified as the primary causative agents.

Obviously, there is a whole set of nonlocational determinants of branch performance including the familiar marketing mix "P" variables of pricing, product, promotion, personnel, and other management and operating policies. It appears that the performance-enhancing strategies recommended in the cited case study were primarily of the nonlocational variety such as changes in pricing, personnel, and corporate policies.

A hasty recommendation that the subject bank dispose of 48% to 62% of its branches, which was not made in this instance, would clearly have been totally inappropriate and unjustified. Rather, it seems from that case study that the proportion of truly unprofitable branches that might have to be divested would be between 10% and 21%.

Mr. Thomas is president of K.H. Thomas Associates, with offices in Miami and Philadelphia.

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The '80/20 Rule'

Our consulting experience since 1975 as specialists in branch evaluation and location research exclusively for financial institutions has confirmed our version of the familiar "80/20" rule: Approximately 20% of a financial institution's branches cause 80% of its branch problems. The first or lowest 10% are categorized as problem or serious problem offices often requiring branch divestiture; the second 10% are problem, near problem, or potential problem offices sometimes necessitating such extreme action.

We feel that the conservative approach to branch planning dictates use of our 80/20 rule to trim the fat from the retail branch network as appropriate. The case study cited in the editorial would appear to support this rule. However, going upwards to 40% means cutting into the meat, and at or over 50% would mean cutting into the bone.

We would recommend that serious consideration be given to any such plans to drastically reconfigure a retail branch network. Such radical and irreversible surgery on a branch network might be appropriate if management has decided to change the bank's branching objectives or its entire retail orientation. Otherwise, a typical retail bank or thrift closing 40%-60% of its offices would certainly represent an unusual set of circumstances.

The previously referenced study concluded that a bank or thrift branch needs $20 million-$25 million in deposits today just to break even (see "Study Finds Half of Nation's Branches Unprofitable,' *American Banker,* October 10, 1987, page 3). It was noted that the proportion of all U.S. bank and thrift branches that were or were destined to be unprofitable was at least 40% but as high as 60%, since that percentage of branches had $20 million or less in deposits in 1986.

We agree that there is a generally positive relationship between branch profitability and local retail core deposits. However, this is not a perfect relationship, and bankers must be careful not to equate branch profitability and total branch deposits.

Break-even deposit levels differ among banks and among branches within any bank because of different fixed and variable expense structures. For example, we have seen some branches with deposits in excess of $25 million that are unprofitable because of their cost structures.

Profitability Differs from Deposits

Conversely, it has been our experience that many branches in the $10 million-$20 million range are profitable, and any wholesale recommendation to close branches simply because they are in this deposit range would be a mistake.

In fact, we have seen some small branches with deposits of less than $10 million that are profitable because of low overhead and outstanding loan portfolios. Why would we even have loan production offices with technically no deposits if these facilities were not profitable? Different offices can serve different delivery system objectives and still be profitable.

For these and other reasons it is difficult to generalize on a universal break-even level or even range for all offices in all areas. For those wishing to make decisions with deposit break-even analysis, the conservative approach to branch planning suggests use of relatively low ranges of local retail core deposits.

For example, at the beginning of this decade an assumption of a $6 million-$10 million range for seasoned offices would have been appropriate. Increases in fixed and variable costs, among other things, since then would obviously imply a higher range. An assumed range of $10 million-$12.5 million in local retail core break-even deposits, precisely one-half of the previously-cited study's finding of $20 million-$25 million, would be more representative of the conservative approach to branch planning in today's environment.

Because branch profitability is much more than just the level of total deposits, we prefer use of discounted cash flow techniques (e.g., net present value) over deposit break-even analysis in branch investment and disinvestment capital budgeting decisions.

Many financial institutions, especially the larger ones, have formal branch profitability measurement systems. It has been our experience that most of those who do not have such systems attempt to use some type of informal measurement procedure to try to monitor absolute and relative branch growth, activity, and cost levels. It would indeed be surprising to learn that management and their formal or informal branch profitability measurement procedures have been so far off to allow 40% to 60% of all branches to continue operating if they were in fact

Comment: Page 6 ➡

Something to Say?

Please direct any comments you may have to the editor, William Zimmerman, American Banker, One State Street Plaza, New York 10004. Letters may be edited for reasons of space and clarity.

LETTERS TO THE EDITOR

Nation's Credit Unions Not Merely an Idle Threat

To the Editor:

In response to the comments of Elspeth Revere, president, Woodstock Institute, Chicago, in her letter printed in your June 3 edition ["Credit Unions' Threat to Banks Is Exaggerated," page 4], I would like to remind her that cancer starts out as an insignificant growth but, if not checked, takes over.

I am reminded of the similarity between credit unions and savings and loan associations of 50 years ago, when banks wrote them off as too small to matter and, in fact, even helped them operate. Look at the Federal Savings and Loan Insurance Corp. and the savings and loan industry today.

John A. MacNaughton
President
National Bank of Coxsackie
Coxsackie, N.Y.

Providing Standby Credit Is Costly to Foreign Banks

To the Editor:

We refer to John Holden's article in the May 10 issue of the *American Banker* concerning Deutsche Bank's backup of the Waveland Associates Project standby liquidity facility made available by Mellon Bank, Pittsburgh ["West German Bank Provides Backup for Letter of Credit on Chicago Issue," page 23].

We thought you, as an important publication in the financial community, would like to know that for standby letters of credit, German banks are required to allocate to capital an amount equal to 50% of the regulatory capital-to-assets ratio for commercial loans. These guidelines increase the cost of issuing standby letters of credit relative to U.S. banks, which have no such restriction.

While risk-based capital standards for off-balance-sheet items are currently being considered by U.S. and foreign regulators alike, we believe that the rules affecting German banks are more, not less, stringent than those affecting U.S. banks.

Robert E. Schlegel, Vice President
Douglas S. Byers, Assistant VP
Deutsche Bank AG
New York

Where Congressmen Cash Their Paychecks

To the Editor:

The *American Banker's* page 2 article on May 10 ("Credit Unions Make Inroads into Bank, S&L Markets") was very comprehensive and well done. There was one glaring omission, however, and that was an explanation of why the credit unions continue to escape the federal income taxes that are a major fact of life for banks and thrifts.

Virtually every member of Congress and nearly all of their staff members (and staffs of the committees) are members of the Wright Patman Credit Union, which has its offices in the Capitol Building. That's where the congressmen and their employees cash their paychecks, as well as get their car loans, etc.

Clearly, nearly everyone in Congress has a vested interest in the continued well-being of the Wright Patman Credit Union, so it seems highly unlikely that credit unions will be on the same playing field as the rest of us, at least in the foreseeable future. Talk about conflicts of interest!

James G. Schneider
Chairman
Kankakee Federal
Savings and Loan Association
Kankakee, Ill.

REQUIRED READING

From the Middle Ages to Money Centers

The following is adapted from a keynote address by David C. Cates, delivered April 14 before the Institute of International Bankers, Washington. Mr. Cates is president of Cates Consulting Analysts Inc., New York.

□

THE STUDY OF HISTORY is also our window on the future. This is not because some iron determinism — if we could just discern its laws — shapes our destiny. Rather, the patterns, trends, cycles and sheer disorder of the human record are suggestive of what might lie around the next bend.

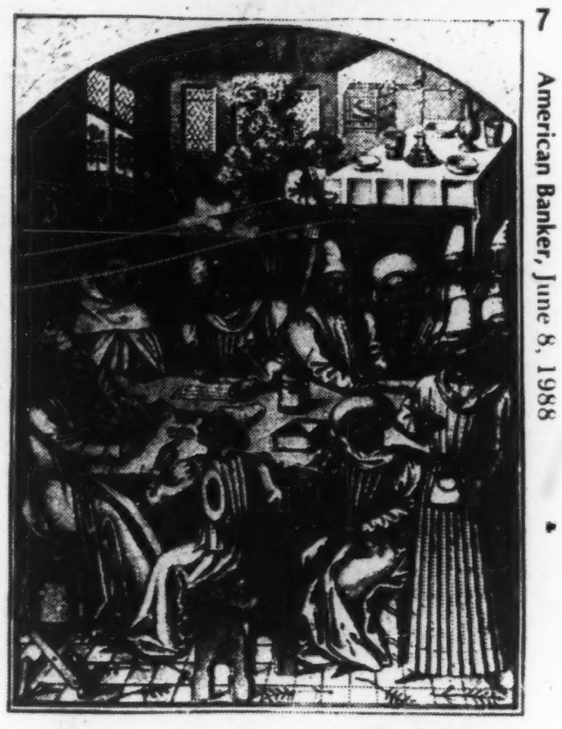
A sense of history, then, enriches our thinking by giving us complex models of plausible outcomes, which we can adjust to the different context of the present. Mere study of the present, where most of us spend our energy, is sterile and misleading. Worse yet, it encourages a dangerous self-importance, as though our management of "now" is all there is.

I will divide my remarks about the rise and fall of international banks into four parts. First, I will recount the surprisingly modern story of the multinational Medici Bank of Florence that flourished and fell during the 15th century. Second, I will describe the war-driven rise of Amsterdam and London as financial centers in the 17th and 18th centuries, a unique evolution that established the models for later systems.

Third, I will raise the question why some larger banks have declined, occasionally to the very threshold of failure. The richest laboratory for such an exploration, I regret to say, is this country from 1974 to the present. Why, in the midst of plenty that has drawn hundreds of foreign banks to exploit banking opportunity here, should there be a steady string of domestic banking disasters beginning with Franklin National, moving on to include First Pennsylvania, Continental, Seafirst, Interfirst, and too many others?

Last, I will raise some conjectures about the future of international banking. What is to be the world role of U.S. banks in an era when this country has rapidly become the world's largest debtor nation?

How does this shift affect the outlook for our money center banks? Will this outlook be further shaped by a decline in the perceived value of deposit insurance? What does all this mean for foreign banks in this country? Finally, what are some of the management challenges that many foreign banks have yet to address?



Bettmann Archive

The de Medici family became prominent throughout Europe in the 14th century as merchants and manufacturers speeializing in wool and silk. This business became the basis for a merchant bank, which flourished in the next century.

Like other Italian merchants, the Medicis traded along very ancient north-south routes that ran through the old cities where they ultimately established bank branches: Venice, Milan, Rome, Avignon, Geneva, Lyons, Bruges, and London.

In that era, these cities were rare, tiny islands of trade and manufacture within a society still based predominantly upon feudal obligations. This was a society of self-sufficient agricultural estates, mutual military assistance, and a church oriented to the complex loyalties and values of the feudal system.

The mainstream culture did not leave merchants and bankers with a lot of prestige or bargaining power among the princes of the larger society. Fortunately, the cities from which bankers operated had won enough political freedom to render them reasonably safe havens for commerce.

The economic basis for this uneasy freedom lay in the landowner's need to import and export bulk products such as wine, wool, olive oil, cloth, or timber, depending on the region; to buy luxury goods such as silk and spices; and to spend, invest, and borrow cash. An increasing use of cash, as the scale of warfare advanced, was to pay for armaments and mercenaries.

Deposit banking — a practice begun in Venice two centuries earlier — flourished under Cosimo de Medici, who directed and built the Medici Bank from 1428 until his death in 1464. There were five sources of funds to support the lending and trading positions of the bank.

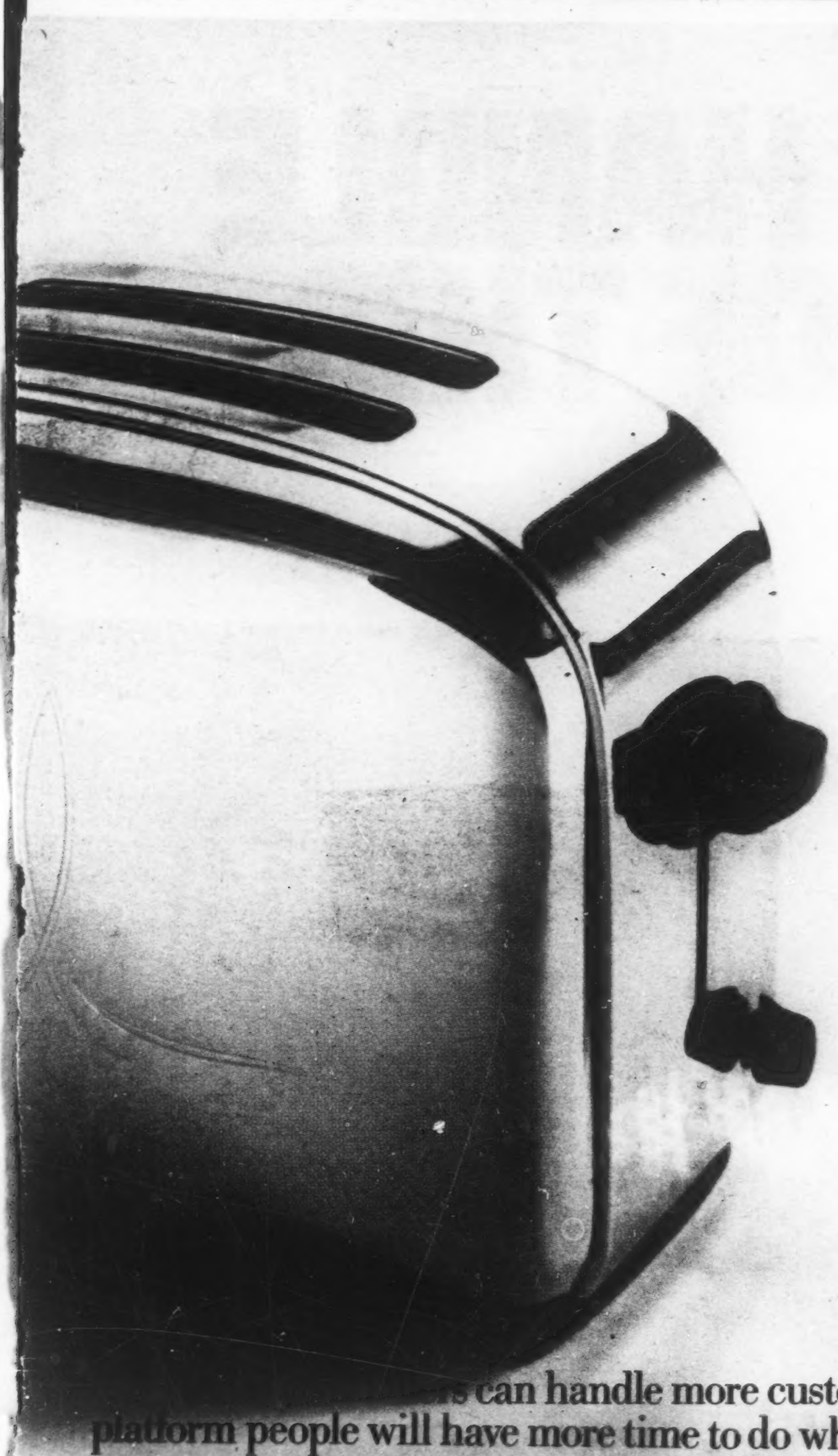
First, there was the capital contribution of the partners. Second, there was the further investment of partner wealth in the deposit instruments of the bank, on which interest was paid at rates ranging from 8% to 12% during the century.

Third, wealthy Italian landowners — despite the criticism of church authorities who thought they should be mending and improving their estates — deposited funds with the Medicis at interest, thus helping indirectly to finance foreign trade. Fourth, merchants and correspondent banks maintained accounts against which to settle transactions or to justify letters of credit.

To illustrate, the bills of a lesser-known merchant would be more acceptable in London, say, if the Medicis were his agent. Finally, princely courtiers and mercenaries used the bank as a haven for their wealth:

"It was not without cause that politicians were eager to place some of their funds with international bankers. They wanted an investment that was safe

Required Reading: Page 8 ▶



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IBM The Bigger Picture

→ Continued from Page 7

from confiscation should they fall into disgrace or flee the country. Real estate could not be concealed, but accounts with an international banking house could be whisked out of the country with a stroke of the pen."

(From Raymond deRoover, "The Medici Bank, Its Organization, Management, Operations and Decline." New York University Press, pages 54-55.)

Ledgers Long Since Vanished

We do not know the leverage ratio of the Medici Bank because there is no surviving balance sheet of any Medici affiliate or of the consolidated whole. The Florence records were destroyed in the sack of Medici property during the revolt of 1494, the bank's final year.

But we do know that a single loan to Charles the Bold of Burgundy, made from Bruges in 1471, was equal to two times capital when it was first written, and was renegotiated in 1478 to more than three times capital before his successor defaulted. The overall leverage of the bank, therefore, was probably substantial, if a single asset could be such a high multiple of capital.

In addition to its deposits, the bank traded merchandise and commodities as agent for others and for its own account. To illustrate, there are detailed records of the costs of a joint venture to import 100 barrels of almonds by galley from Valencia to Bruges in 1441.

Since these had not been presold, they were somewhat haphazardly jobbed and retailed during that spring and summer. Eleven barrels had to dry out in an attic. (Could this be the origin of our taste for salty nuts?)

The bank's chief asset-generating function, however, was its dealing in bills of exchange, the dominant credit instrument of the era. A bill of exchange, typically issued to finance cross-border trade, was written in one place and currency, to be collected in a different place and currency.

Bills were also traded in the money markets of the major cities. Time intervals increased both the credit and exchange risk. Shipping customarily consumed three months between Italy and London, two months between Italy and Bruges, and one month between Bruges and London — or Paris/Bruges or Paris/London. To be sure, news travelled faster than freight, but the communications gap was still daunting.

A key question: How could a 15th-century banking business, depending then as now upon the reasonably predictable calculation of interest, be conducted within a system of church regulations that strenuously forbade usury — namely, any obligatory payment of interest? In the church view, usury was an invasion of property rights, since "more is asked than was given."

Nor was it an irreligious age in which sophisticated city dwellers attend church only at Christmas and Easter, ignoring its rules at other times. The Medici bankers were as devout as the rest of Christendom. To illustrate, a famous painting by Hans Memling shows the Medici Bruges manager, Tommasso Portinari, stark naked on the occasion of the Last Judgment, earnestly praying as his life is weighed. Nearby his similarly clad wife pleads on his behalf, as a cast of thousands await their turn.

Scriptural Loopholes

The answer — different for lending than for deposit-taking — lay in certain tiny cracks in the regulatory structure. Church law forbade fixed and certain interest, but did not bar the discounted "adventure of principal" if the potential for loss stood between the loan and its collection.

Thus bills of exchange were discounted, the origin of our current practice of discounting. The amount of discount served to mask compensation for credit and exchange risks, all carefully computed and negotiated.

Deposit interest was a different story. Interest could be paid and recognized as such, but only if understood to be a discretionary "gift' rather than a contractual obligation. It was the reputation of the bank, not a legally enforceable guarantee, that stood behind the implied promise to pay.

When Philippe de Commines, a Flemish diplomat to the French court, tried to collect back interest from the failing Lyons branch in 1478, he was rebuffed. He kept writing his friend Lorenzo, then head of the bank, for years without success.

The Medici Bank also had a funds-transfer function. For example, as fiscal agent for the Vatican, the bank handled all papal collections and disbursements in Europe and England.

The disbursements were for military subsidies, among other things. The collections, much more important, arose from the widespread sale of offices and indulgences, a significant source of papal revenue.

For all clients, the Medicis made paper entries from one branch to another in favor of correspondent banks, merchants, and other Medici affiliates. Because of the network of branches and correspondents operating in every country of Europe, these paper entries were a useful substitute for scarce coin and its shipment — a risky and costly endeavor.

> Deposit banking flourished under Cosimo de Medici, who directed and built the Medici Bank from 1428 until his death in 1464.

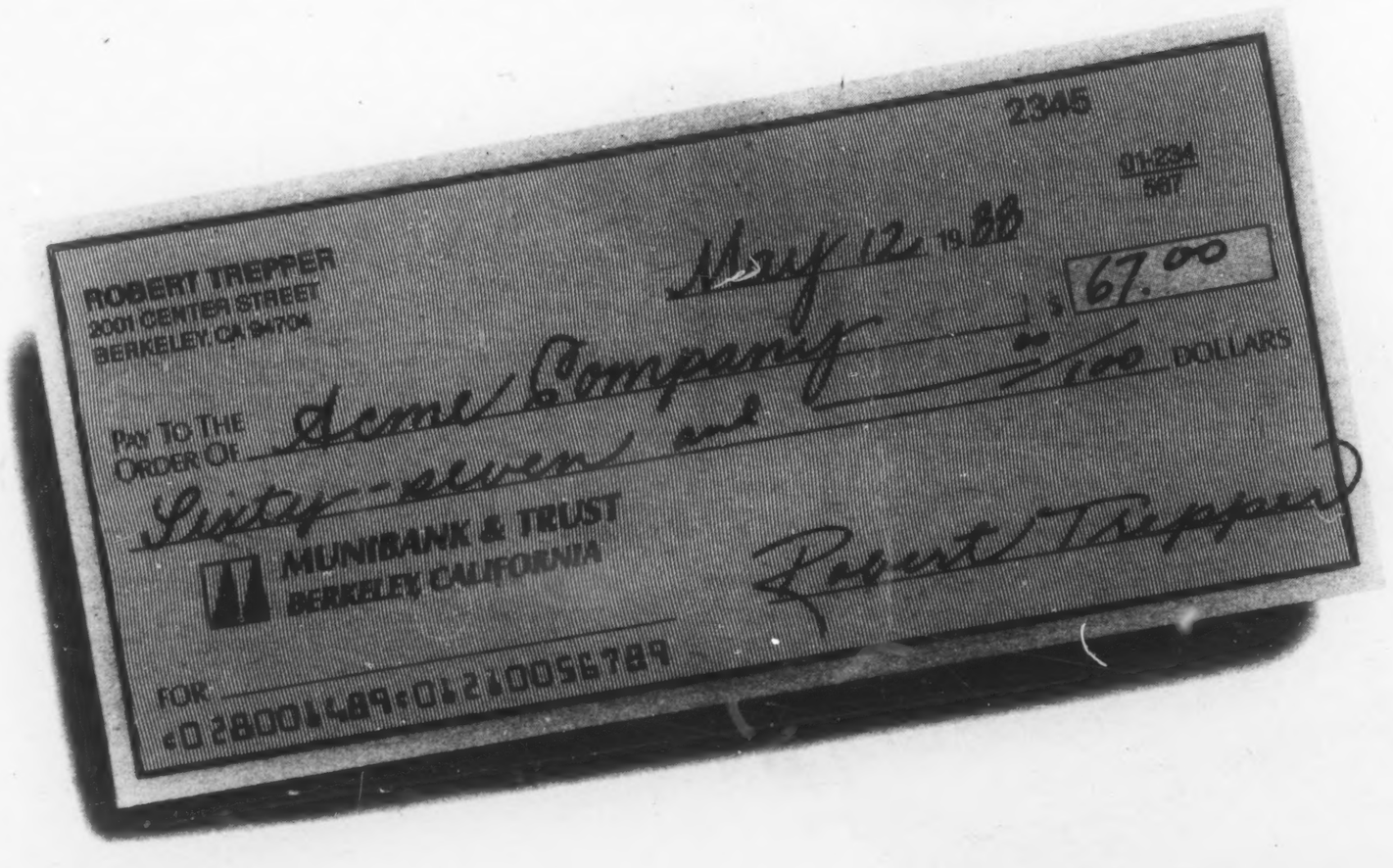
Underlying all this international activity was the fact that medieval Europe through the 15th century was, in fact, an economic "common market," before the rise of sovereign nations made international finance more difficult.

Cosimo organized the bank's branch system on a decentralized basis, unlike other Italian banks of the time. Partnership agreements governed the operations of each Medici branch, which together formed a system of controlled affiliates.

These documents show that the Medicis contributed roughly 60% of the capital, with the balance coming from loyal lieutenants — perhaps including a former branch manager — but always including the current branch manager. Under Cosimo's management these detailed agreements explicitly forbade the manager to lend to princes, a rule broken shortly after his death.

The affiliate system had the advantage of giving the local manager a stake

WHY HANDLE ALL OF THIS,



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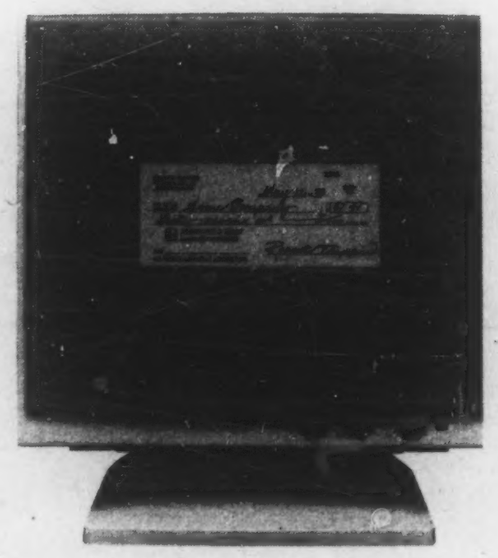


in a piece of the business too remote to be managed directly from Florence. The system had another advantage as well. It limited the legal liability of the total enterprise.

Thus in 1451, when a FIorentine merchant sued the Bruges branch for defects in a shipment of wool originating from the London branch, the municipal court upheld the Bruges manager's argument that the two were separately organized businesses, despite their common control by a single family.

The decline of the bank began in the mid-1460s. There were four causes. First, successor management after Cosimo's death in 1464 proved lax and directionless.

Too much authority was soon given to local, poorly controlled managers. Cosimo's son Piero was ill and bedridden, surviving his father only by two years. He is on record, however, as urging retrenchment.

Piero was succeeded by Lorenzo the Magnificent, ruler of Florence, statesman, patron of the arts, and companion of humanists. Lacking interest in business, he relied on his adviser, Francesco Sassetti, a former branch manager in Lyons and Florence, to run the whole enterprise and to generate the substantial partnership returns Lorenzo needed for household expenses. Thus the bank probably became more leveraged at the very time that its business problems intensified.

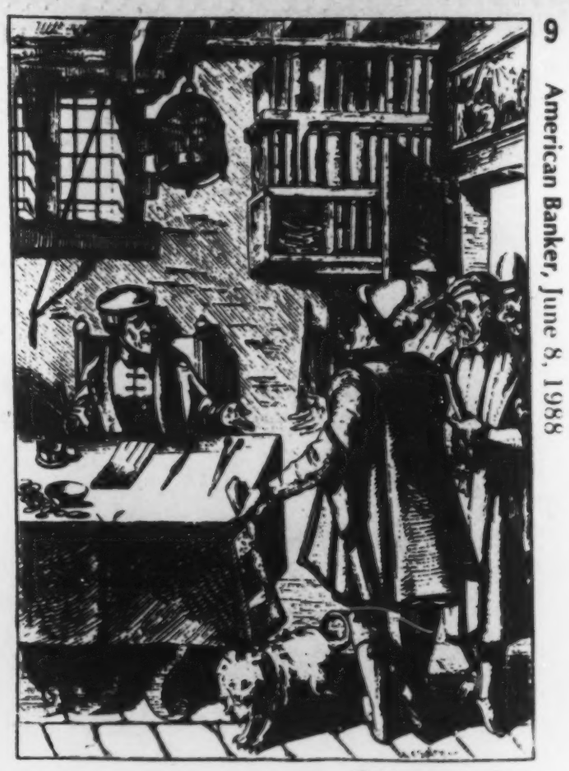
Second, trade fell off from the 1460s through the rest of the century. One mark of this falloff was that gold rose steadily in relation to silver, the medium of commerce. Since bills of exchange were usually denominated in silver, and deposits usually in gold, the adverse shift in the monetary ratio probably caught the Medicis in a classic bind between the relative values of assets and liabilities.

We also know that the wool and cloth trade was hurt by the disruptions of a civil war in England, and by the deliberate English recruitment of Flemish weavers and other artisans. This shift toward self-sufficiency cut the bank's trading volume in a key commodity.

A third problem was that Lorenzo's money needs led Sassetti to relax the former ban on sovereign lending. In the renewal of the partnership agreement with Bruges in 1471, for example, Portinari was, for the first time, permitted to finance his patron and client, Charles the Bold, Duke of Burgundy and ruler of the Low Countries.

A few years earlier, the London branch had caved in to the insistent financial demands of Edward IV, who proved unable to reconcile a bitter civil war. Charles was killed in 1477. Lacking a male heir, his small duchy was annexed in the next year by his son-in-law, Maximilian of Austria, who then insisted on further loans. The defaults on all these loans led directly to the failures of both the Bruges and London affiliates.

An early example of a debt-for-equity swap — a familiar topic of discussion today among those who ponder the reduction of Third World debt — occurred in 1478 when the Bruges affiliate tried to settle its loan to Maximilian. In return for principal reduction, the Medicis gained the right to collect harbor tolls at Gravelines, a Channel port near Calais. The steady decline of the wool trade with England, however, did not bode well for the value of this property.



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The final problem, which closed the Medici Bank for good, was simply the rising tide of political risk throughout Europe. The rapidly advancing scale of warfare had begun to destabilize the pluralistic system of feudal loyalties in favor of a few powerful nations, themselves in mortal contest.

These tectonic agonies would not end until Napoleon's defeat at Waterloo in 1815. One consequence of these national wars was that finance, truly international in the 15th century, became nationalized, with sharply different systems of public credit and levels of interest rates.

Should it surprise us that the world's first multinational, multibank holding company should come and go during the course of a single century? I don't think so. The social environment was simply too hostile to permit long life to merchant banking firms.

The death of kings took center stage as a spectator sport, and cathedrals, not bank headquarters, merited "landmark" designation. Though one or two Italian banks can trace their corporate lineage to the 1500s, no others can. The earliest still-surviving commercial bank is the Royal Bank of Scotland, founded in 1695; the earliest still-surviving Dutch bank is the Hoop Bank, founded in 1760.

Still another mark of the alien ideology of the time was the decision of Pope Innocent VIII in 1488 to legalize — and organize — the persecution of witches. This system, which established inquisitors and informers, would be copied intact by the Protestant religions. Across the next 200 years, several hundred thousand fatalities would occur.

Center Shifts to Amsterdam, London

The ever-more-costly wars of the next three centuries quickly weakened smaller players like Florence, Venice, and Burgundy, in favor of a few emerging nations: France, Spain and England. Yet nothing was settled, and incessant wars of attrition continued at ever higher cost. In this environment, the new art of public finance became as important a factor in victory as military and diplomatic skill.

This was how tiny Holland could succeed in its 80-year rebellion against Spain, which had inherited the Low Countries from Maximilian. True, Holland had advantages.

For one thing, Spain faced formidable supply-chain problems in subduing the distant Netherlands. Second, Spain was suffering elsewhere from what Paul Kennedy calls "imperial overstretch', a frontier of commitments that finally reduced it to an exhausted sec-

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➤ Continued from Page 9

ond-class power by 1650. Third, the Dutch, then preeminent traders to the Far East, controlled the world's best merchant marine and navy.

At least as important, however, was the triumph of Amsterdam as an international money center, serving the nation as an engine of war finance. The growth of the Amsterdam money market, much larger than any predecessor, was funded in part by the liquid wealth of prosperous Low Country traders and manufacturers, and in part by "flight capital" from the rest of Europe.

The surplus of savings was so huge, in fact, that Dutch war bonds could be floated at rates as low as 4%, and commercial loans at less than 2%. The Amsterdam market even helped to finance Spain, albeit at rates of interest as high as 40%. (The average Spanish rate paid to bankers was 12% to 14%.)

Merchants Pulled the Strings

It helped, too, that the government was largely controlled by merchants whose understanding of the importance of credit, budgets, and the timely repayment of debt was bred in the bone. Another consequence of merchant government was that state overhead remained low, a condition that eased the burden of debt service.

By contrast, the great wealth of Spain was never enough to meet its huge commitments. The gold and silver from America was so heavily pledged to Genoese and German bankers (later ruined by the ultimate Spanish default) that Spain itself was reduced to a copper currency.

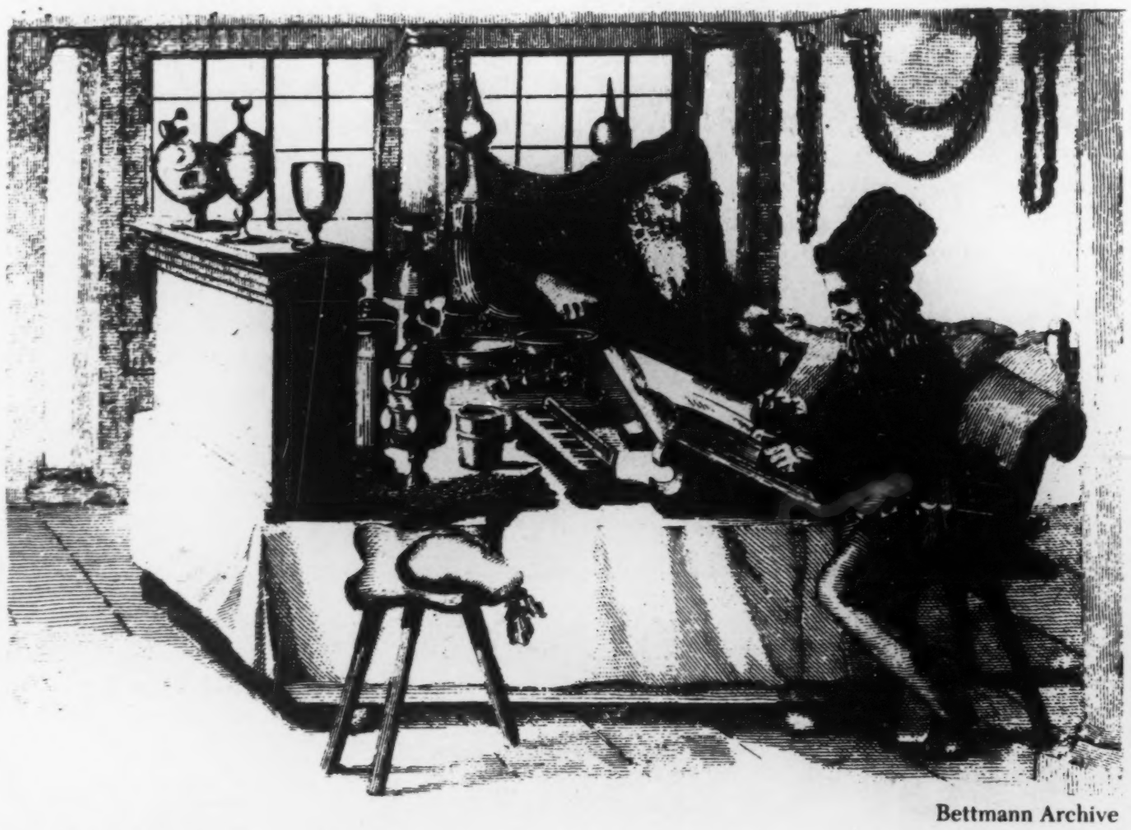
The real problem was that Spain lacked a system of public finance immune from the royal tendencies to grant tax-sheltered monopolies, to tax everyone else unpredictably and arbitrarily, to suspend interest and principal payments at will, and even to declare bankruptcy, as Spain did for the first time in 1557.

Worse yet, in an absolute monarchy where the nation is, by definition, an extension of the kings's household, there is far more incentive for the wealthy to purchase offices and monopolies from the crown — and to transfer wealth abroad — than to accumulate liquid wealth at home available for impersonal investment.

These bad habits meant that Spain depended heavily on external lenders, at much higher cost than Holland had to pay. On top of this, the Inquisition, then in full flower, managed to drive away most of the nation's merchant class, the very source of renewable wealth that Holland enjoyed in abundance.

In the next century, London began to rival Amsterdam as the world's financial power, and finally erected the capital markets edifice — building on Italian and Dutch models — that the rest of the world would copy in the following century. For a start, English finance benefited from a powerful merchant class that helped Parliament dismiss James II, the last of the Stuarts, in 1688.

This step forever deprived the English monarchy of fiscal authority, henceforth vested in Parliament. It helped too that William III, the Dutch prince who succeeded James, brought Dutch principles of public finance to London.



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The relative trustworthiness of the capital market in London — like Amsterdam — attracted both domestic and foreign savings seeking impersonal investment opportunity. Finally, strong overseas trade and the first stirrings of the factory system of production created the domestic liquid wealth needed to bear an affordable tax burden and to finance and service war bonds. It was this rapid creation of wealth, in fact, that let England emerge financially unscarred after 1815, ready to fund domestic and foreign investments for the next century.

France, though the largest continental power, suffered from many of the same problems that blocked Spanish finance. These were a divinely ordained monarchy, with the power to suppress opposition; a hated and corrupt apparatus of taxation; a trade-damaging system of internal customs collection; financial incentives that encouraged the wealthy to purchase offices and monopolies rather than to create a flow of liquid savings; and the flight of capital to more secure money markets, notably Amsterdam and London.

Unlike Spain, however, France enjoyed a degree of domestic savings invested in war bonds, although the rates paid were always higher than in London. The 1789 revolution, however, damaged public credit until the early 1800s.

As the costs of war rose during the century, the English financial advantage became ever more critical. This is made clear in the accompanying table, adapted from Paul Kennedy's study.

Three points stand out. First, England was at war for 65 out of 127 years in the period 1688-1815. Second, the annual cost of war rose steadily from five million pounds in the late 1600s to 75 million pounds a century later.

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Third, England was able — through taxes and loans — to self-finance its war debt, even after 1780 when Holland became a French ally and withdrew financial support from England.

Finally, English war bonds were issued during the century at rates ranging from 3% in 1751 to highs of 9% in 1711 and 7% in 1782. The average yield on the 3% consols of 1751 was about 4% during the remainder of the century.

The relative resiliency of the French and English systems of public credit in the early 18th century is revealed by the conduct of both governments on the occasion of simultaneous outbreaks of "paper money madness" — one in Paris, the other in London, both beginning around 1718 (quite by coincidence) and culminating in 1720.

In Paris, John Law, an exiled Scot, brilliant professional gambler, and amateur economic theorist, persuaded the credulous Duke of Orleans (regent of France following the death of Louis XIV) to do two things: first, to establish a central bank to issue its own notes, and second, charter the Mississippi Company that would reap riches by trading with Spanish America.

The trouble with the first idea was that the regent liked it so much he ordered the issuance of far too much paper against totally inadequate coin reserves. A panic followed when the royal bank refused to honor its notes with coin.

Matters did not improve when the crown then authorized informers to collect silver and gold from households. This was followed by a 50% devaluation of the paper. No wonder there was a cross-border flight of gold and silver, and a subsequent distrust of paper money and banks.

Scottish banking was the principal model upon which English country banks and, later, the American banking system were based.

The trouble with Law's second idea was that the American trading opportunity was grossly misrepresented to French investors, so that the huge and very fashionable speculation soon proved worthless, with widespread financial ruin aggravating the currency crisis.

In England, another fraud — the South Sea Company, chartered by Parliament — led to a similar frenzy of speculation and ruin. The damage, however, was contained by the prompt action of Parliament.

Restitution was demanded and collected from the personal estates of South Sea directors, a liquidating dividend was paid to all shareholders, the company's debts were honored in full, and its receivables from the public were cancelled. These Parliamentary actions calmed the public, preserved the currency, and restored public credit.

"Enterprise, like Icarus, had soared too high, and melted the wax of her wings; like Icarus, she had fallen into a sea, and learned, while floundering in the waves, that her proper element was the solid ground. She has never since attempted so high a flight."

(From Charles Mackay, "Extraordinary Popular Delusions and the Madness of Crowds." London, 1852, p. 88.)

It is worth noting that the development of English commercial banks in this era was stunted by the note-issuing monopoly granted by Parliament to the Bank of England in 1694. This monopoly was in return for the willingness of investors in this private bank to subscribe war bonds.

Meanwhile, Scottish banking flowered in the 18th century, beginning with the first commercial bank charter in 1695. Scottish bankers soon developed a competitive, market-driven, innovative, and self-regulatory system — with very few failures — that financed industrial growth in the north more efficiently than England could manage. Scottish banking, in fact, was the principal model upon which English country banks and, later, the American banking system were based.

Financing of British War Costs

1688-1815

Years	Elapsed years	Total cost (mil. of pounds)	Cost per year (mil. of pounds)	War loans as % of total cost
1688-97	9	49	5	34
1702-13	11	94	9	31
1759-48	9	96	11	31
1756-63	7	161	25	37
1776-83	7	236	34	40
1793-1815	22	1,658	75	27

Source: Paul Kennedy, "The Rise and Fall of the Great Powers: Economic Change and Military Conflict 1500 to 2000." Random House, New York, 1988.

Why Banks Fall

In the preceding section, I have emphasized the rise of capital markets, rather than banking systems or individual banks. They are not quite the same, of course.

London, for example, became a worldwide hub of finance without the benefit of large commercial banks. In general, however, savings, investment, and the institutional structure that connects the two all occur together.

Do they fall together? We can begin to answer this question by first isolating the factors that encourage the development of financial systems. I see five such factors.

First, there must exist a base of successful trading and manufacture to generate a surplus of wealth, in a form that turns into cash fairly often. Second, there has to be a financial market, an institutional structure of banks, dealers, brokers, and arrangers that mediate liquid wealth into rational and reliable investment.

Third, there has to be a deeply established public belief that the game is not too rigged, that dishonesty is accountable, and — most important — that government is constitutionally restrained, especially in its power to tax. To the extent, in fact, that an economically rational elite is not in charge, savings will flee the market, just as Spanish and French savings fled to Amsterdam.

Fourth, there needs to exist a commercially favorable public infrastructure to include reasonable degrees of equitable and predictable (not necessarily low) taxation, a fair and accessible system of justice, universal education, affordable insurance on all manner of commercial risks, a postal system, a coast guard, roads and bridges, and the like.

Dissent Must Be Tolerated

Finally, there must be a widespread public ethos in favor of commercial goals and values, coupled with reciprocal values that stress the responsible exercise of business power. This economic ideology, I hasten to add, can only be effective when it is disciplined within a wider intellectual climate that promotes the arts and sciences, and tolerates dissenters as well. The economic importance of such a climate, of course, is that it nourishes the spirit of inquiry and experimentation which is at the bottom of the creation of wealth.

To the extent nations have met these five tests, they have produced large, influential, and world-class banks. When nations falter, however, there is no iron determinism that says their banks must decline as well.

The linkage, in other words, between national performance and bank performance is not a close one. Britain and its banks provide an example.

Though the nation itself has been in relative economic decline since 1946, its largest bank, National Westminster, has emerged as a worldwide presence whose stature, soundness, and profitability make it a force to reckon with. A contrast of a different sort is presented by the histories of Standard Chartered Bank and Hong Kong Shanghai Bank. Both were British-chartered in the 1860s to serve colonial financial needs.

The one was to be based in London, then the center of Empire, while the other was to be headquartered in the Far East, close to the colonial marketplace itself. The relative fortunes of these two banks in recent decades seem to illustrate the importance of domicile in fostering the prosperity and momentum upon which banks thrive.

It also illustrates the importance of locating a bank's decision-making as close as possible to where the needs of its customers are determined. For colonial clients in 1900, London was that place; in 1988 it is not.

The contrast between Hong Kong and Standard Chartered may also say something about management. But since I am not a close observer of these two banks I can't document this difference.

What I do understand, from many years of direct observation, is the management factor in U.S. banking. This experience has taught me over and over again that management — the ability to guide and control a business — is the real key to the success or failure of banks.

And our banks have had more than their share of both. We seem to produce a fair number of excellent banks whose practices are studied and copied far and wide, not only in this country but abroad. We have also witnessed too many failures and near failures, beginning in 1974. This has not happened because of economic hard times (which only make things worse), but because of a peculiar pathology that seems to destabilize a small fraction of U.S. bank management, leading occasionally to crisis.

To describe this lurking disease (to which most of our bankers, I believe, are immune), I will practice some amateur sociology upon you. We are dealing, after all, with a recurring pattern of executive behavior, not merely with aberrant personalities.

Such an analysis, furthermore, allows us to think about remedies more plausible than aptitude tests or group psychotherapy for bank chairmen. Besides, it's fun to indulge our American pastime of characterizing distinctive cultural and organizational styles. Since we do it about English, Japanese, and Swiss bankers (among others), why should Americans get off without the same treatment?

I want to begin with the observation that our banks — large and small — exited the cautious 1950s with highly authoritarian command structures that would make the military blush. There were four reasons for the paternalistic despotism of bank chief executives in that era.

First, the prevailing banker goal during the three decades following the trauma of widespread bank failure in 1933 was to build impregnable fortresses of soundness and to say "no" to virtually all other ideas. One consequence of this negative thinking was to discourage initiative from within, and to concentrate power in the hands on the "old man who saved the bank." The social contract in banks of that era,

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in other words, traded job security for subservience.

Second, the prestige and the self-importance of such leaders was fed — beyond that of other corporate chiefs, even of larger businesses — by their unique knowledge and control of the communities they dominated. In a time when "relationship banking" was a privilege, not a commodity, long before borrowers learned to confuse bankers by ignoring them, the chairman of almost any bank was a larger-than-life figure, to be feared as well as courted.

Formidable Personalities

Names like Edward Eagle Brown (First National Bank of Chicago), William S. Gray (Hanover Bank of New York, my first employer), and Edward Byron Smith (the Northern Trust Company of Chicago) are just a few reminders of the tyrannical personalities of yesteryear. At the same time, men like these created a lasting image of the executive function in American banks. In the wrong hands, as I shall soon point out, this model can prove destructive.

Third, we have to look even further back in history to find the roots of our innocent belief in heroes. I'm afraid we are prone to this belief, egalitarian rhetoric to the contrary.

A simple insight is presented by the history of American place names, across 250 years of settlement. The first colonists of New England — frightened, brave, and collective — named their communities after "home": Plymouth, Hartford, Framingham, Worcester.

Over the next two centuries, the emerging individualism of Americans created a hybrid place name: Thomasville, Barryville, Galesburg, Pittsburgh. The founder's name was attached to an old-country suffix.

After the Civil War, the cult of individualism intensified to the point where the European suffix was dropped altogether! To illustrate, in the American Southwest (mostly settled after 1865), place names became a characteristically bald tribute to the ego of some long-forgotten founder: Gallup, N.M.; Roswell, N.M., Winslow, Ariz.; Cameron, Ariz.; Prescott, Ariz.

By contrast, Spanish names for the same or adjoining places were characteristically religious: Tes Marias, Vera Cruz, San Antonio. American Indian place names typically summarized topographical features with no reference to personality.

Here are some examples drawn from Navaho: Cottonwoods in a Circle, Ariz.; Water Springs from a Cleft, N.M.; Parallels Stretch Across — a reference to the bridge at Gallup, N.M. This principle of impersonal naming, curiously enough, comes full circle, for it most resembles early English names: Oxford, Sussex, Worcester, Plymouth.

The fourth and final cause that I see behind the traditional authoritarianism of U.S. banks is rooted in the fact that dynasty is the sequel to individualism. The successful 19th-century founder of an American mill, a town, or a bank created a family asset that could be strengthened through intermarriage and passed on free of taxation.

Though a few banks originated as partnerships or syndicates (Morgan, Bank of New York, Brown Brothers), most American banks were founded and managed by families. This is documented in a remarkable 1962 study prepared for that scourge of banking, Rep. Wright Patman, D-Tex.

Dynasties Revealed

The study forced the unprecedented disclosure of the largest 20 stockholders of each of the nation's largest 200 banks. It showed the continuing and pervasive control of large American banks by local families: the Harris and Smith families in Chicago, the Kempers in Kansas City, the Frenzels in Indianapolis, Fishers in Detroit, Rockefellers in New York, and so forth.

Since these dynasties were invariably influential in their communities, it is not hard to understand the power wielded by the bank chief, whether a family member or a proxy for the family, both inside and outside the bank. Because of the family roots, moreover, it is easy to understand how management principles could develop without a system of checks and balances on the exercise of power.

> The squat man with cigar ashes on his vest no longer stands a chance, regardless of merit.

For these four reasons, then, the power of the U.S. bank chief executive officer was shaped by images and expectations that led to authoritarian management as a norm. This may have been appropriate to a Depression and post-Depression era when the reflex of the chief was to say "no."

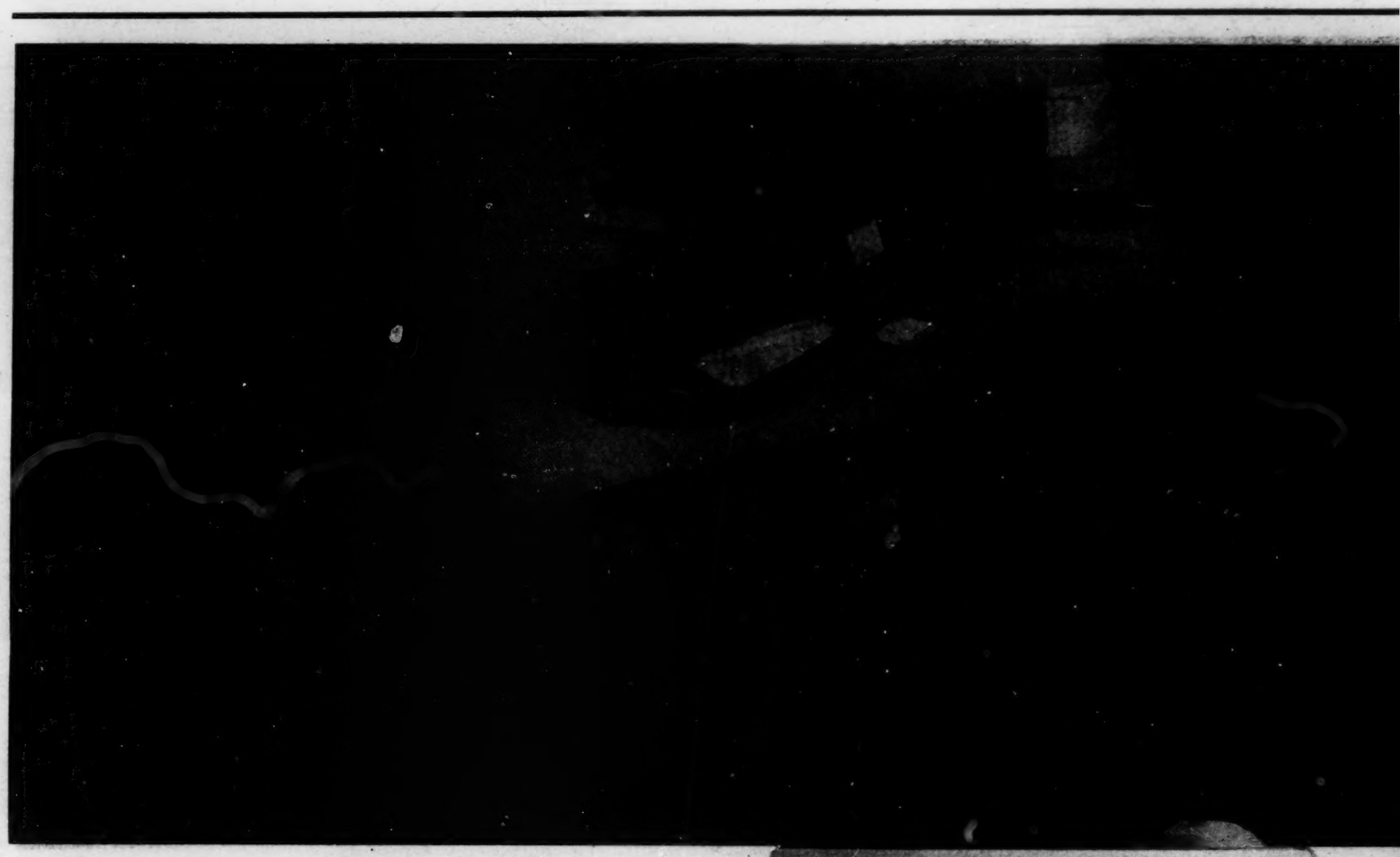
That generation was finally discredited during the expansionist 1960s. Who needed musty fossils to guard fortresses that the world no longer cared to besiege? The new generation wanted to say "yes."

What the fossils bequeathed to their successors, however, was a command structure that gave far too much power to one man. What were the influences that would now begin to shape the "yes" generation of bankers?

In part, there was a careerist inducement to build some fun back into banking. The danger was past, and the John F. Kennedy administration was actively encouraging a much freer spirit toward bank growth, competitiveness, and accommodation. Those who heard the message were in the national mainstream. Snow White would not only be revived but wedded by the Prince of Entrepreneurship.

Second, the institutional stock market began to discover bank stocks in the early 1960s, establishing for the first time a relentless dialogue between investors and management that came to have a profound effect upon the latter. As a bank stock analyst during the entire decade, I was able to see at first hand how managements reacted to the siren songs we sang about earnings-per-share growth and price-to-earnings ratios.

Many remained coldly oblivious — Morgan Guaranty and National Bank of Detroit, for example — maintaining that their business was to run a bank, which analysts could take or leave. By 1970, however, most of the largest 100 banks had come to recognize the many benefits of a high stock price, to meet corporate and personal goals, and were



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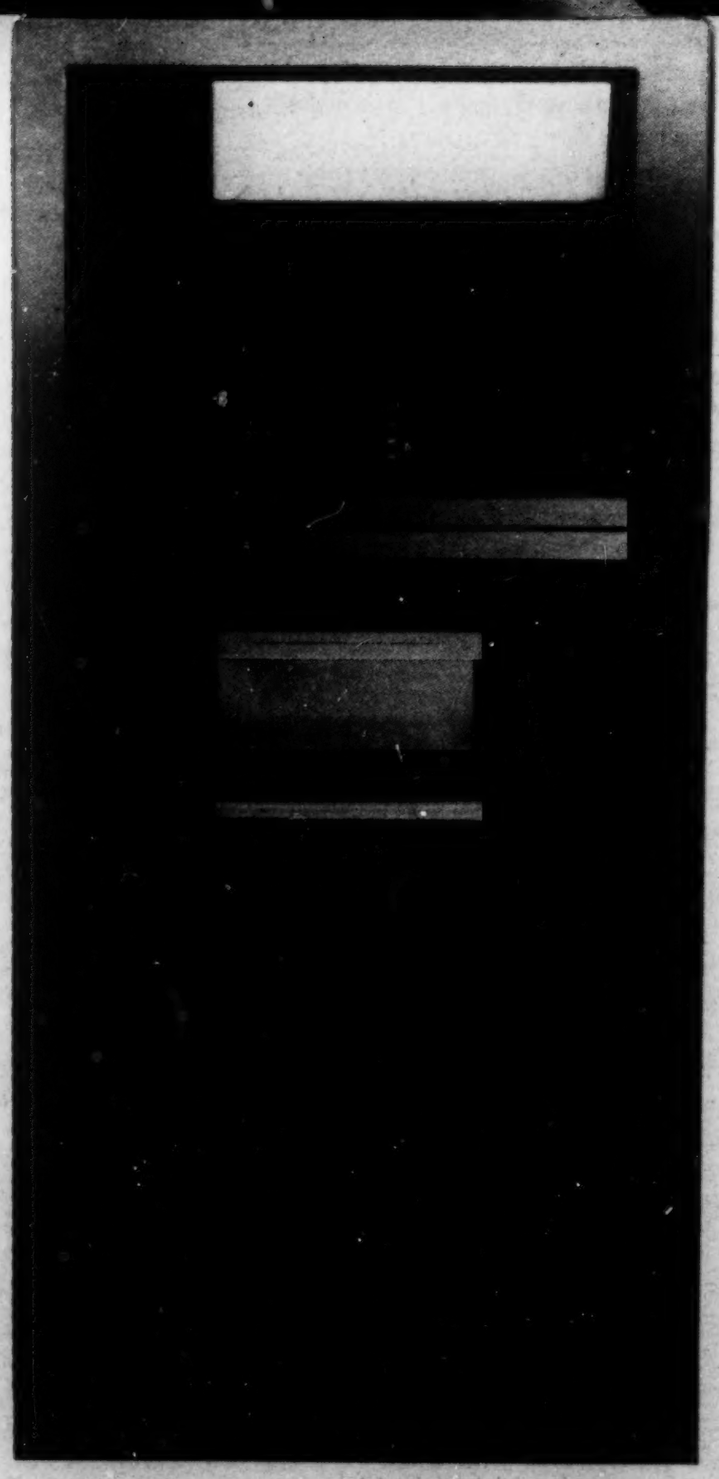

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beginning to fashion an active initiative toward analysts.

Prestige within community and industry circles became a strong factor reinforcing this new fashion. Bankers and their directors wanted to be seen as shedding the cobwebs of a Depression management style.

Lure of the Limelight

They wanted to be admired as business leaders, not as bankers who said "no." What better mark of distinction in this new environment than to enjoy a high price-earnings ratio and to be able to flash a recent research report written by Merrill Lynch or Goldman Sachs?

A trend-setting event shaping this evolution of attitude was the so-called investor relations dinner held by Citicorp in October 1971. Its purpose (illusory, as it turned out) was to break the shackles that bound Citicorp stock to the rest of the bank stock market.

For Citicorp stock to take wing, Walter Wriston personally reasoned, bank stock analysts must be deliberately excluded from the invitation list, in favor of equity research directors, stock portfolio managers, market economists, and others who might appreciate the message that Citicorp was really another Xerox.

The important promise of the evening was Mr. Wriston's personal commitment to pursue an earnings-per-share growth target of 15% annually. In the next few days the stock surged relative to other bank stocks.

The precedent set by Citicorp's dramatic evening further unsettled the weaker heads out there in the banking industry. Analysts began to hear similar promises being made, as though this was the only way to get attention.

Worse yet, too many managers started to believe in these commitments, undertaking whatever policies were necessary to meet such earnings-per-share growth goals. One of these policies was management by objective, a nice-sounding idea (why shouldn't one have goals at work?), but one easily abused to produce whatever loan volume would generate the required earnings growth. In these cases, bank strategy became the slave of rapid EPS growth, with no quarterly interruptions permitted.

> Too many "essential" banks have been weakened by excesses and misdirection over the years.

To be fair, we should recognize the counterargument that a ruthless competitive environment requires a bank to shave spreads, do deals, introduce new products, build market share, and promote a high stock price. My answer, perhaps yours as well, is that the first duty of a business called a bank is to justify the trust of its funds providers. A bank's second duty is to secure its long-term survival. The duty to build quarterly earnings-per-share for the benefit of the institutional stock investor should rank below these two prime goals.

The allure of stock price was not the only siren song to tempt the new generation of bankers. The other Lorelei was the emerging need of the business press — *Fortune, Forbes, Business Week,* among others — to create readership by featuring personal profiles of executives in articles and photographs.

The executives themselves, of course, become instant celebrities, at least at home. Since many of these stories are promoted and guided by company-paid public relations advisers, the new trend meant that the publicity policy of many a business (including banks) would emphasize the celebrity nature of its CEO. Here is a man who, if asked, is available and fit for talk shows, interviews, photo opportunities, and other media events.

Vanity, Thy Name is Publicity

All this leads to vanity, of course, which is itself dangerous. It contributes as well to two other damaging consequences.

One of these is the trivialization of the leadership selection process. As in national politics, there is a selection bias in favor of the executive who is trim, photogenic, and popular with analysts and press. The squat man with cigar ashes on his vest no longer stands a chance, regardless of merit.

The other damaging consequence of celebrity is executive isolation. The new celebrity is too often cut off from corrective and constructive dialogue with directors and subordinates. Fame, however spurious, creates remoteness.

Finally, the combination of vanity and isolation is a dangerous mixture when coupled with corporate goals driven by earnings-per-share growth and stock price performance. In a management climate corrupted by these factors, there is no room at all for a loyal opposition, whether on the board of directors or among the senior subordinates.

Such a bank is unconsciously patterned after a divine-right monarchy, not a merchant republic. The competitive odds, I think, still favor the latter, as in the 17th century.

Bob Abboud describes in detail how this evil alchemy worked at First Chicago, corrupting the incorruptible toward the funding crisis of 1974-75 that earned him his chairmanship. A tyrant himself, he had the presence to say "no" to growth in favor of survival.

Each large American bank in crisis since 1974 has had its own particular management history, which I will not recount here, but in all of them were present the incendiary ingredients I have tried to summarize here.

As far as I can tell, European, British, Japanese, and other international banks are managed according to very different principles. For whatever historic or cultural reasons (I will not trouble you with my guesses), you seem to have a deep and universal reliance on collegial management.

What do I mean by this? For one thing, it means that such banks require a high degree of consensus in order to change course, enter a new market, commit to a large credit, and so forth. It also implies a high degree of organizational and career continuity, rarely interrupted by senior resignations or firings, or staff reorganizations.

It means an inward orientation of the top management, who externally remain somewhat anonymous. Finally, as Steven Davis points out from his interviews with "excellent" banks, the collegial style at its best tolerates the pres-

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→ Continued from Page 19

ence of a loyal opposition. A senior or junior officer who presents a reasoned case for a different course of action is not penalized for "defying the will of the chief" (as too often happens here).

More Than Just Another Business

If banking were just another business, like shopping centers or commercial laundries, the foregoing discussion would be nothing but sociological trivia. The trouble is that there is a public interest at stake. This is true even in the absence of Federal deposit insurance.

Large banks — whether Swiss, Swedish, or American — are keepers of their nations' savings, the stewards (usually) of payments systems, occasional stabilizers of capital markets, and symbols of national responsibility. Measured against these awesome functions, deposit insurance is redundant. Yet some chief executives here seem to have taken for granted the Federal safety net and use the too-big-to-fail theory to underwrite irresponsible bets.

It's as though government subsidy has altered the balance that should desirably exist between greed and fear, the capitalist emotions. Central banking and deposit insurance, with the best intentions, have diffused the fear, but left the other unchecked. This proves, at least to me, that the soundness of banks is ultimately dependent not upon government but upon the character, professionalism, self-discipline, and economic ideology of the managers of banks.

I'd like to conclude by raising five questions. What does debtor-nation status, now a reality for the U.S., mean for U.S. banks? What is the outlook for our money center banks?

What might happen to the perceived value of federal deposit insurance, with what consequences? What opportunities are present here for non-U.S. banks? Finally, what challenges do foreign banks face that may threaten their present comfort?

Debtor-Nation Status

Britain was the world's chief creditor nation during the 19th century. The U.S. succeeded Britain for most of the 20th century, and Japan has since emerged as the world's largest creditor while our country has plunged into international deficit. My reading of the work of economists persuades me that the U.S. will remain in deficit indefinitely, despite improvement in our balance of trade.

What does this mean for banks? Judging from history, creditor status conveys three advantages upon the internationally competitive banks of a nation.

First, it means relatively low-cost funds and capital. The savings surplus is so huge that it is satisfied by relatively low yields. Meanwhile, long-term investment opportunities attract a further surplus that competes to lower the cost of business capital.

This was true in Britain in the 1840s, as accumulated wealth from textile manufacture sought investment in railroads. The same seems to be true today in Japan. Savings interest rates, government bond and corporate stock dividend yields are so low as to point to very favorable costs of capital.

Second, the volatility of funding and capital costs may very well be less in a creditor nation than in a debtor nation, since the latter is more economically and financially dependent upon others.

Third, banks in a creditor nation benefit from their intimacy with the businesses that are making big direct and portfolio investments abroad. These ties create opportunities that debtor nation banks tend to miss. Such banks, like good restaurants near major intersections, enjoy a strong and natural traffic.

By contrast, debtor nation banks (according to this view) suffer from a relatively high cost of internal capital (however slight the difference), a relatiVely deficient flow of savings, perhaps a greater volatility of funding cost (with all that this means for sure-footedness), and a relative absence of customer opportunity. Thus France and the U.S., for example, had slightly higher levels of interest rates than prevailed in London.

Bettmann Archive

The U.S. did become the world's creditor after World War I, but the prevailing sense of international isolation ("no entangling alliances") suggested few of the financial opportunities that Britain had seized early in the previous century. To remind you of that magnificent passion, let me quote from the song of the directors of the Fidelity Fiduciary Bank in the movie "Mary Poppins", as of 1900: railways through Africa; dams across the Nile; fleets of ocean greyhounds; majestic, self-amortizing canals; plantations of ripening tea.

By contrast, American banks and merchant bankers were too busy, for most of the era, surviving the Depression and financing World War II to take advantage of the international opportunity this nation enjoyed. To be sure, Citibank, Chase, and Bank of Boston built local banks here and there (my cousin audited Citibank's branches in Japan in the 1930s). And Morgan Guaranty decided as early as 1962 to become a major international presence.

The second chance for most other large U.S. banks came rather late in the game. During the 1960s, the flood of dollars owned abroad created an offshore market that the New York banks helped to develop and lead. By the end of the decade, dozens of American banks (from New York, San Francisco, Chicago, Dallas, Detroit, Philadelphia, Charlotte, among others) had "opened in London."

For most of these banks, the post-1960s internationalization was too shallow to be sustainable. In recent years, of course, the offshore bridgeheads have been largely dismantled: D-day turned into Dunkirk.

Is this because the original internationalization of U.S. banks in the 1960s was a kind of "imperial overstretch," a collective strategic error? Or is it because the tide of worldwide capital flows began to turn against this country, or some combination of both?

Part of the answer lies in recalling the difference between National Westminster and Standard Chartered, two banks chartered by a nation eclipsed by the rise of the U.S. One emerges as a worldwide giant, the other struggles to maintain its independence.

This analogy suggests that our nation contains some survivor international banks, but also suggests that we may have a surplus of such banks. If so, it will be because our new financial disadvantage relative to creditor nations (Japan, Switzerland, Germany, the U.K.) will gradually deprive our international banks of the reliable, recurring profitability necessary to maintain all of them as independent entities.

How are the excess banks to diminish? There are four paths, I think, few of them plausible. One is to acknowledge defeat gracefully and shrink from worldwide to regional status, much as Bank of America has done.

This path is easier to follow if you have always been the largest banking presence in California. It is much harder if you are a New York City giant whose local core of funding and lending is relatively insignificant. Your local justification doesn't exist!

The second path is to seek one's own dismemberment — the sale of this affiliate, that department — in the hope that you can gain a soft landing as a piece of your former self.

A third path is to seek an acquirer for the whole bank, an unlikely prospect (I think) unless the pieces are first put up for sale. The fourth alternative is to deny reality by continuing a too-aggressive strategy in the face of declining stature and creditworthiness.

This course of action, at worst, may result in failure and nationalization (as Continental was nationalized). One thing is clear, at least to me: The competitive position of money center banks appears generally to have become so weak today that perhaps half the group will cease to exist as independent entities within a few years.

Who will acquire all or part of our surplus of international banks? My answer is twofold: foreign banks and American superregionals. A small example of the first path is the 1986 purchase of Schroder Bank by Industrial Bank of Japan. There is as yet no example of the second.

The Federal Deposit Insurance Corp. was never designed to stretch its coverage of bank failure beyond the insured amount (now $100,000 of deposits). Yet in 1984 a precedent was established, in the case of Continental, by which the FDIC now stands behind all the obligations of essential banks.

At best, the FDIC may seek to finance new ownership of an otherwise doomed bank (First City National of Houston). At worst, a large bank in crisis for which there is no buyer will be nationalized.

What is meant by a bank too big to fail? In one sense, it is a bank whose domestic and cross-border continuity is essential, in order to prevent business breakdown and to defend the worldwide image of American banking as an international resource lying behind our "key currency" status.

In another sense, a bank too big to fail is simply any bank whose affairs are simply too complex to be liquidated. Since the largest 200 banks in this country clearly fall in this category, the credit of the FDIC is quite over-committed.

It would be reassuring to be able to argue that the national commitment to banking continuity is such that the FDIC is irrelevant since all large-bank obligations (to the extent necessary) would be automatically honored by the U.S. Treasury. The trouble is that there are only a few press releases — no statutes — outlining the federal commitment. Further, Congress, upon which any contingency plan must depend, will predictably shy away from legislation until some crisis is truly at hand, with unpredictable consequences.

My point is that the rational holder of claims against large U.S. banks will increasingly look to the creditworthiness of those banks themselves as a bulwark of safety, and will depreciate the role of government as an immediately reliable shield. As this happens, the transition is apt to be painful.

Too many "essential" banks have been weakened by their excesses and misdirection over the years. The signs of this are readily at hand: not only have many of our money center banks been steadily downgraded since 1982 by Moody's, Standard & Poor's and other rating agencies, but — worse yet — the secondary market in money center bank holding company subordinated notes shows yields of 60 to 80 basis points over comparable-maturity Treasuries.

At these spreads, the market is consigning the banks' securities to "junk" status. This is hardly a corner of strength from which to battle the new challenges arising from our debtor status.

It seems to me, from my limited study of leading Japanese, English, Swiss, and other offshore banks, that many of you enjoy a tremendous opportunity in this country. For one thing, you are largely core-funded in your domicile nations.

For another, you often seem to be protected by oligopolistic pricing prac-

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June 8, 1988, American Banker

THE MIDWEST

Rust Belt Recovery, Mergers Refuel Bank Stocks

Continued from Page 3

The revival of the Rust Belt economy is due in large part to the benefits of the declining dollar and the boost it provides to the Midwest's agricultural and manufacturing base. The strong domestic economy also helps.

With the recovery now intact, banks are enjoying growing loan demand and much improved credit quality. For example, the 19 Illinois banks tracked by Mr. LaManna at William Blair had a 7.3% median gain in earnings per share for the first quarter of this year. The median level of nonperforming loans at the quarter's end for those banks was 0.72%, down from 0.76% at yearend 1987 and significantly better than the industry average.

Among the banks followed by Mr. McGinnis at the Milwaukee Co., interest margins declined slightly in this year's first quarter to 4.59% from 4.65% during all of last year. But Mr. McGinnis believes the decline resulted from a new accounting standard, FASB-91, that took effect at the beginning of the year.

FASB-91 requires that fees on loans be realized as income over the term of a loan. Under the previous accounting method, loan fees could be realized as interest income in the year of the loan's origination.

"Although net interest margins appear to have declined in the first quarter, we believe that, net of the accounting change, there was an increase," Mr. McGinnis wrote in a report dated May 24. "This increase is the result of the improving fundamentals of the midwestern economy."

Midwest bank stock prices have also been rising because the continuing trend toward mergers and acquisitions has built a takeover premium into many of them. In his May 20 report, Mr. LaManna wrote, "This year's superior performance of Illinois bank stocks relative to the market and other NASDAQ-traded banks nationwide is at least partially attributable to their investment appeal as takeover candidates."

While bank mergers and acquisitions in the Midwest have slackened a bit since the October stock market crash, the consolidation phase continues. And Mr. Stieven believes the phase could continue for five more years.

The Milwaukee Co. tracks the performance of five Wisconsin bank holding companies and three more that are headquartered outside the state. Last year, over 22% of the Wisconsin banking assets followed by the firm were the target of industry consolidation.

Mr. McGinnis believes that banks are making acquisitions as a takeover defense. That is, if a bank is large enough, it may be able to decrease its potential to become a takeover target.

Too Many White Knights

But don't expect a lot of hostile takeovers, Mr. McGinnis said. Hostile attempts are prone to fail because "in the banking industry there are just too many potential white knights." Moreover, hostile attempts can distract employees and customers of the banks, and that "acts as a significant deterrent to hostile takeover attempts in the industry."

The Midwest does have some regional banks that would make attractive takeover candidates. Mr. McGinnis' list of potential targets includes:

- Citizens Banking Corp., a $2.3 billion-asset company in Flint, Mich. The company was selling at a discount to book value in late May.
- First Interstate Corporation of Wisconsin, a $1.5 billion-asset bank holding company based in Kohler, Wis. The company's largest shareholder is pushing management to sell the bank holding company. Unless earnings turn around, "it is possible that the company could be a takeover target."
- First Midwest Bancorp, a $1.6 billion-asset bank holding company in Naperville, Ill. The company is based in suburban Chicago, the most attractive banking market in the Midwest. "There are only a limited number of possible takeover candidates in the area, of which First Midwest is one."
- First Wisconsin Corp., Milwaukee, the largest bank holding company in Wisconsin. The $6.9 billion-asset holding company has made acquisitions in Chicago and Minneapolis. In mid-May, the stock was selling at 7.5 times estimated earnings. That was one of the lowest levels among the banks followed by the Milwaukee Co. "Fundamentals are improving, and at current prices the company would have to be considered a very attractive takeover candidate."
- Marshall & Ilsley Corp., Wisconsin's second largest bank holding company, with assets of $6.4 billion. The Milwaukee-based company has an attractive franchise that produces good returns for shareholders. "They appear to be an ideal acquisition target" even though Marshall & Ilsley may become a superregional. ■

S&L Execs See Political Ploy in FSLIC Payout

Continued from Page 1

sheet was $13.7 billion in the red because of the projected costs of closing some 400 problem thrifts.

Roger Martin, a Federal Home Loan Bank Board member, on Tuesday denied the liquidations had any political overtones. "We have a priority list of the institutions that we must deal with, and these two just rolled out. There was no consideration of the political aspects at all," Mr. Martin said.

The decision to liquidate the two thrifts was born of a desire to help reduce the premiums thrifts must pay for deposits, he said. American Diversified and North America had been paying interest rates 145 basis points more than the national average. Since last March, the Bank Board has been working to reduce the deposit premiums paid by insolvent thrifts, particularly those in Texas, Mr. Martin said.

"We have reduced the Texas premium alone almost 60 basis points," he said. "This has been done through work we've been doing through the institutions, plus the closings." He noted that the first eight institutions closed under the Bank Board's Southwest plan were institutions with a high cost of funds.

"As a matter of fact, out of the next 30 that will be dealt with in Texas, 18 have a high cost of funds," he said. A reduction of 10 basis points in the cost of funds would have a salutary affect on the industry's profits, he said.

"It is almost $1 billion a year in pretax profits to the industry," he said.

Bert Ely, a thrift consultant based in Alexandria, Va., concluded the Bank Board had no alternative but close the two California institutions. Six other S&Ls with assets of more than $450 million each fit the profile of the two California thrifts, he added. These high-rate-paying institutions have few local depositors, relying instead on brokered deposits from investors in other parts of the country.

Mr. Ely said his analysis showed that the two California thrifts relied more on brokered funds than any other institutions in the country.

As of Dec. 31, the average insured deposit account at North America was $84,010, compared with a national average of $7,345, he said.

American Diversified's insured accounts averaged $80,807.

"That's 10 times the industry average," he said.

Mr. Ely said many insolvent thrifts are getting more of what he calls "minijumbos," or brokered deposits in the $80,000-to-$90,000 range. This indicates that money managers placing funds in institutions with high rates are making certain they have insurance coverage for their principal and interest.

The six other institutions Mr. Ely referred to have insured accounts averaging from $30,538 to $58,366. Two of the S&Ls are in California, and the remaining four are in Texas. "What's finally come out here is that it takes cash to do these deals," said Mr. Ely.

Liquidations Called a 'Bold Move'

James Butera, congressional lobbyist for the National Council of Savings Institutions, called the California payout "a bold move." But he said he was shocked by the resolution costs.

Assets from the two liquidated institutions will be managed by the FSLIC.

A spokesman said none of the assets would be managed by the Federal Asset Disposition Association, a quasi-governmental agency created by the Bank Board in 1985 to aid the FSLIC. Some members of Congress are trying to legislate the asset disposition group out of existence and have asked the Bank Board to avoid entering into new relationships with the organization.

White House spokesman Marlin Fitzwater said on Tuesday that estimates as high as $50 billion on the cost of bailing out the thrift industry are wrong.

Asked if a taxpayer bailout might be needed for the FSLIC, he responded, "Right now, we think the regulatory approach is the right one, using only $10.8 billion of borrowed funds that will be repaid by healthy thrifts under a congressionally approved financing plan." ■

Morgan Ponders Software Upgrade

NEW YORK — Morgan Guaranty Trust Co., which has been using much-modified older software from Automated Financial Systems Inc., is negotiating a contract to upgrade to that vendor's AFS Level III Lending System for its commercial loan portfolio.

Thirty-six large banks and thrifts use the Level III Lending System, including 6 of the 10 largest commercial banks and a Morgan Guaranty affiliate. The $1.27 billion-deposit Morgan Bank (Delaware), Wilmington, already uses Level III.

Morgan Guaranty is the nation's fourth largest bank with $45.8 billion in deposits. At the end of 1987, its domestic commercial and industrial loans totaled $3.33 billion, and its domestic and foreign commercial and industrial loans totaled $12.28 billion.

Running on mainframe computers by International Business Machines Corp., the AFS Level III Lending System is an integrated on-line loan accounting package with more than one million lines of code.

It features such functions as multiple accruals of interest and fees on each note, on-line inquiry about customer totals with supporting detail, more than 100 standard report formats, full nonaccrual and chargeoff processing, cash flow forecasting, handling of participations, and a general ledger interface.

The other banks in the top 10 using the system are Bank of America, Chase Manhattan Bank, Manufacturers Hanover Trust Co., Security Pacific National Bank, and Wells Fargo Bank. ■

Stockton Savings Reorganizes

STOCKTON, Calif. — Stockton Savings and Loan Association has completed its reorganization into a holding company, the California Financial Holding Co. The 100-year-old state-chartered thrift unit will continue to operate under its present name. Stockton has assets of $762 million and operates 14 branches in the Central San Joaquin Valley. ■

REQUIRED READING:

Continued from Page 20

tices at home, further supported by governments that nurture your development and prestige in various ways. Third, to the extent yours are creditor nations, you benefit from the home "traffic" of clients seeking investment here.

Fourth, the leading banks of creditor nations tend to benefit at home from relatively low funding and capital costs. Finally, our leading credit rating agencies, Moody's and Standard & Poor's, have given many of you a boost in your worldwide funding strategy by blessing you with their top credit ratings.

I will single out two hurdles I expect that most of you will have to surmount within the next five years. The first is that your "consensus cultures" — the collegial management style I spoke of earlier — are luxuries that work well at home but are difficult to export.

If you don't bend, you'll have too many of your nationals responsible for important decisions in a country they may not deeply understand, waiting at their desks till late at night for head office approvals. If you do bend, the chances are that your American work force will not fit easily into your management style.

Banks that seem to be solving this difficult challenge include National Westminster, whose large and successful bank here is American-led, and Industrial Bank of Japan, which has left in place the American leadership of Schroder Bank (now IBJ Schroder). Within this country, a bank that has solved a similar problem is First Wachovia, where the widely admired management style of Wachovia Bank has been extended to the very different culture of First Atlanta without loss of momentum or identity for the latter. Such examples, in my opinion, deserve to be studied.

The second challenge has to do with your financial disclosure, a field I think I understand. By and large, your banks do not do an adequate job of informing your creditors, investors and other "stakeholders" of your true condition and performance.

The test is a simple one. Is the financial record of the past presented in a manner — involving both format and substance — that permits plausible projections of future performance?

Analysts like me have been catalysts for over two decades guiding American bank disclosure to fulfill this criterion. Your banks have never been subjected to this steady pressure from an analyst community, and as a result your shareholder reports are not particularly useful as financial documents. ■

Poll Finds People Gloomy About Their Financial Future

33% of Respondents Do Not Agree That Reward for Hard Work Is Independence

By LYNN BRENNER

NEW YORK — Americans at all income levels are pessimistic about their ability to achieve long-term financial goals, according to a consumer survey for the International Association for Financial Planning released Tuesday.

One-third of the respondents don't agree that "if you work hard enough you can achieve financial independence."

The survey is the second annual consumer poll and for the second time it was conducted for the association by Reichman Research Inc. Two groups of respondents, representing a cross section of the American public, and a separate sample of households with annual incomes of $50,000 or more, were interviewed by telephone in February.

Consumer pessimism about the future, strongly evident in the 1987 survey, has increased this year. For the second time, both groups of respondents said they are worried about the national budget deficit and the trade deficit. For the second time, 39% of both groups said the next generation will be "worse off," and have fewer financial opportunities than are available today.

This year, respondents added the "threat of a recession or depression" to their list of major economic concerns. Their fears of inflation and higher taxes also increased this year.

Compared to 1987, there is a 50% increase in Americans volunteering that inflation and the cost of living are some of the "biggest economic and financial concerns" facing their households. That concern has more than doubled among Americans in the higher income levels.

Whose Advice Would Consumers Use?

Professionals consumers consider most qualified to manage their financial affairs (base: those who think it would be beneficial to have finances managed by a professional)

	Total Public			Total Higher Income		
	1988	1987	Change	1988	1987	Change
Financial planner	50%	48%	+2	60%	57%	+3
Accountant	34	36	-2	38	39	-1
Banker	18	17	+1	9	7	+2
Attorney	16	13	+3	11	17	-6
Stockbroker	12	14	-2	14	12	+2
Insurance agent	8	7	+1	6	5	+1

Source: IAFP's 1988 "Americans Cope With Their Finances" Public Awareness Program

People Grow Concerned About Taxes

Taxes jumped this year from fourth to second place is the ranking of household financial concerns. Among higher-income Americans, taxes rank first, tied with paying for their children's education.

Americans at all income levels still rank saving for retirement and for their children's education as their most important long-term goals.

But they're even less confident than last year of achieving those goals. This year, for example, 49% of all respondents said they are afraid of outliving retirment savings — an increase of 17% over the 1987 survey.

"The bad news is a consistent perception that the American dream is fading," said Hubert L. Harris Jr., president of the association. "The good news is that hard reality is sinking in, and people are readier than before to engage in financial goal setting and planning."

Clearly, this represents an opportunity for financial planners. Respondents were asked which of several professionals would do the best overall job of helping clients plan and budget their finances. In reply, 32% of the total public said a financial planner, 25% said an accountant, and 14% said a banker. Attorneys got a 14% vote, and insurance agents and stock brokers each drew only 4% of the vote.

Respondents in the higher income group, when asked the same question, expressed confidence only in the abilities of financial planners (48%) and accountants (23%). Only 5% of upper-income consumers ranked bankers and attorneys as people who would do the best overall job of helping clients plan and budget finances. Insurance agents and stock brokers each drew an even smaller 3% expression of confidence.

Nearly one-third of Americans with household incomes of $80,000 or more use financial planners; 22% of households with income between $60,000 and $79,999 and 18% of households with income between $50,000 and $59,999 use financial planners.

Among consumers who have financial planners, 71% say they are very satisifed, a 7% increase over last year. Ninety-two percent say they are very satisfied or somewhat satisfied.

The increase in satisfaction after the October stock market crash is probably because most financial planners' clients have well-diversified portfolios, said Robert A. Hewitt Jr., chairman-elect of the International Association for Financial Planning.

"Even if they took a hit on October 19, it was only to a portion of their portfolio," he said. These clients were also probably psychologically better prepared for a market crash than the average investor, because planners have educated them to think in terms of economic cycles, he said. ■

Possible Compromise Emerges on Cashing Government Checks

By ROBERT M. GARSSON
Washington Bureau

WASHINGTON — Consumer groups pushing for legislation to force banks to cash government checks are expressing concern over a possible compromise that would require the checks to be deposited electronically.

"We are very uncomfortable with the suggestion that direct deposit should be the only means of doing government check cashing" for low-income persons who do not have a bank account, said Peggy Miller, a lobbyist for the Consumer Federation of America.

Most likely, such a proposal would link the government check-cashing program to a "lifeline" checking account — an inexpensive, no-frills service. The House Banking Committee is actively considering whether banks should be required to offer lifeline accounts to low-income individuals.

The government check-cashing proposal has become a threshold issue for both the banking industry and consumer groups.

Bankers have resolutely opposed legislative proposals that would require them to cash government checks for people who do not have accounts, warning such measures would open the door to fraud on a grand scale. Of all the consumer legislation being discussed on Capitol Hill, banks are said to oppose most adamantly the government check-cashing proposal.

The Consumer Federation, the American Association of Retired Persons, and other consumer groups argue that low-income and elderly persons without bank accounts are forced to pay fees to check-cashing services that can run nearly one-third the value of the check. The issue is one of a handful that the groups are unwilling to give up on, according to Ms. Miller and others.

The concept of linking government check cashing to direct, or electronic, deposit is only beginning to take form on Capitol Hill, and no sponsors have emerged.

"I have no idea where it came from or who is pushing it," said Ms. Miller. "But I hear about it everywhere I go. Members and staff are asking about it.

"We are very, very worried that they will consider it a compromise between the bank's position of not wanting anything and our proposals," she said.

The Consumer Bankers Association, a trade group that focuses on retail banking issues, is not pushing the idea of direct deposit as a compromise on the check-cashing issue, said Joe Belew, the organization's president.

"I think that the two issues are going to come together," he said. "There is a common ground."

Ms. Miller said low-income and elderly persons often do not trust financial institutions and are unlikely to accept a system that forces them to give up a paper check. If paper and electronic options were offered, however, some might migrate to direct deposit over time, she said.

The consumer groups want banks to cash most government checks of $5,000 or less — exceptions would be made for checks issued by government agencies in other states, for example — for both customers and noncustomers. Banks would be able to require photo identification cards and would be permitted to charge up to $2 for cashing the check.

Bankers Call Safeguards Insufficient

Bankers call those safeguards insufficient.

"First, nobody knows how much it costs to ensure against fraud," said Mr. Belew. "Not all government checks are good. They can be forged too."

Moreover, he asked, "why should this service be forced on banks?"

The postal service, he said, could cash government checks for people without bank accounts. Alternatively, the federal government could agree to indemnify banks for losses from fraud or states could regulate check-cashing services more closely.

Ms. Miller said losses from fraud have been small and could be covered by an average charge of 10 cents per check out of the $2 fee her organization believes banks should charge for government checks.

The General Accounting Office, a congressional watchdog agency, said last month that the federal government issued 559 million checks, with a face value of $621 billion, in fiscal 1987.

The agency said 142,632 of those checks, with a value of $63.7 million, were cashed fraudulently. However, 92,000 of the fraudulently cashed checks involved the spouses of deceased Social Security recipients, and Treasury recovered much of that money.

The House Banking Committee is expected to begin formal consideration of major banking legislation late this month or early in July, and consumer issues are expected to receive close attention.

The Senate already has passed major banking legislation that addresses some of the issues being pressed by the consumer groups. The Senate Banking Committee, however, has begun addressing issues not included in the bill that might come up in a House-Senate conference, including government check cashing.

Ken McLean, the Senate panel's staff director, convened a meeting of banking and consumer groups in a largely unsuccessful effort to obtain a consensus on some of the issues.

A requirement that direct deposit be used for government check cashing was only "one of the ideas" talked about, he said.